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Commissioner of Internal Revenue,
Petitioner

v.

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v.

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v.

[illegible]

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[illegible]

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 237

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
ROBERT LEE MERRITT AND WINNIE MERRITT

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
G. WESLEY MERRITT AND FANNIE J. MERRITT

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
JACK D. MERRITT AND WILLA GRAY MERRITT

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
VIRGIL BOWLING AND GLADYS BOWLING

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
JAMES O. WATSON 3rd AND LUCY J. WATSON

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

PRELIMINARY STATEMENT

A petition for a writ of certiorari has been filed in *Paragon Jewel Coal Company, Inc.* v. *Commissioner*, No. 134. The Commissioner filed a memorandum in opposition in that case and then filed the present petition as a protective measure. This brief is directed to the petition in No. 134, since the petitioner in that case, rather than the Commissioner, is the party whose interests are adverse to respondents.

QUESTION PRESENTED

Respondents, operating as various partnerships, mined coal under non-terminable agreements with the lessee of the mineral lands from whom respondents received a price per ton which varied in accordance with changes in the market price of coal. The question presented is whether respondents are entitled to an allocable share of the percentage depletion allowance based on the amounts they received for coal produced or whether the lessee, Paragon Jewel Coal Company, Inc., is entitled to the entire percentage depletion allowance based on its gross income from the property, undiminished by the amounts paid to respondents.

STATEMENT OF THE CASE

A. Respondents Agreements With Paragon.

C. A. Clyborne acquired by purchase and lease certain coal bearing lands located in Buchanan County, Virginia. In 1951 Clyborne created petitioner, Paragon Jewel Coal Company, Inc. (hereinafter "Paragon"), the corporate stock of which is held almost exclusively by Clyborne and his wife. After Paragon was formed, Clyborne assigned the leases he had acquired to his corporation for an overriding tonnage royalty. This royalty was deducted by Paragon as an operating expense and reported by Clyborne as long-term capital gain. (Merritt App. 9)[1]

Under the assignments Paragon assumed the obligation to pay minimum royalties, tonnage royalties and land taxes, all of which were deducted as business expenses or taxes. Paragon made substantial investments on the properties in order to prepare itself to process, ship and market the coal, all of which were deducted as a business expense, depreciation or amortization of mine development costs. In fact, all expenditures of Paragon with reference to the properties were so deducted for tax purposes. (Merritt App. 12, 46, 47).

Paragon's experience was as a processor and seller of coal rather than a producer; furthermore it lacked the capital to go into the coal producing business. Since the coal mining business is very hazardous, Clybourne did not want to expose his personal funds to the dangers inherent in the coal producing business. Rather than mine the coal itself, Paragon elected to rely on others exclusively for the production of coal and it entered into oral

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[1] Respondents filed two briefs and an appendix below. The latter document is entitled "Appendix for Merritt, et al, Petitioners". We have filed nine extra copies thereof with this brief. This appendix will be cited herein as "Merritt App.".

agreements [2] with respondents and others to mine the coal by a method known as drift mining.[3] (Merritt App. 29-32, 38, 39).

Beginning in 1951, Paragon entered into oral leases with a number of operators including respondents, all of which were similar in terms. Under such agreements the operator was allocated a specific surface area under which it might mine. The operator agreed to mine the coal within that area and deliver it to Paragon at the operator's own expense. All expenses of opening, developing and operating the mine were to be borne by the operators. Paragon agreed to pay a fixed price per ton of marketable coal, but it was understood that the price would, and in fact it did, vary with the market. The operators were required to use and pay for the services of Paragon's engineer and to operate and maintain their mines in accordance with state and federal mining laws and regulations. The agreements were silent as to who was entitled to depletion. They contained no termination date and nothing was said between the parties on this subject. (Paragon App. A3, A4)

Usually it would require about six weeks of preparatory work before an operator could mine coal. Even then the operation is unprofitable. A drift mine must be developed by driving a main entry, air courses, cross sections and rooms to create enough working areas so that a sufficient daily tonnage can be produced to make the mine profitable. This requires from at least six months

[2] In many instances in Buchanan County, Virginia coal leases are oral. It was common practice in that area to transfer coal interests and rights by verbal agreement. (Merritt App. 32-34).

[3] Drift mining is done by driving a horizontal shaft into the hillside and extracting the coal from seams which are usually less than three feet in thickness. It is an underground mining operation, which does not disturb the surface of the land. Drift mining is a difficult and economically marginal operation. (Paragon App. A3)

to a year and often longer. (Merritt App. 57, 58, 61, 62, 67, 83-85, 94).

The operators were encouraged by Paragon to invest in their mining operations so that their mines could be developed and coal produced. Respondent, and the other operators were willing to undertake these burdens because they understood that their operations could not be terminated until they had mined their respective areas to exhaustion and that they would recive a fair per ton price based on the condition of the coal market for the marketable coal they produced. (Merritt App. 91, 92, 97-99)

B. Determination Of The Tax Court.

The Tax Court decided that Paragon was entitled to the entire percentage depletion allowance. Such determination was based on a finding that the contracts did not contain a specific statement that they were not terminable at the will of Paragon and the contracts did not contain a specific statement that the operators had a right to mine to exhaustion. From these facts the Tax Court concluded that as a matter of law the operators did not have such rights under the contracts.

C. Decision Of The Court Of Appeals.

The Court of Appeals disagreed with the conclusions of law of the Tax Court. It held that by virtue of their contracts and the operators' respective expenditures under them, the operators shared with Paragon an economic interest in the mineral within the rationale of *Parsons* v. *Smith*, 359 U.S. 215.

D. Paragon's Position Before This Court.

Paragon advances three reasons for the granting of its petition. First, it contends that the decision below is in conflict with *Parsons* v. *Smith*, supra; then it claims that

contract mine operators are foreclosed from the depletion allowance by the provisions of Section 631(c) of the 1954 Code; and finally it asserts that the decision below will have serious litigation-breeding consequences.

E. Commissioner's Position On Paragon's Petition For Write of Certiorari.

The Commissioner has filed a memorandum in opposition contending that Paragon's petition should be denied. This memorandum states a belief that the decision of the Court of Appeals is "basically in conflict with *Parsons*", and refers to the "clear error of the decision below", but no attempt is made to identify the "basic conflict" or set forth the "clear error".

ARGUMENT

A. The Decision Of The Tax Court of Appeals Is Proper And In Accordance With *Parsons* v. *Smith.*

Paragon contends that under *Parsons* v. *Smith,* supra the depletion allowance is available only to a taxpayer who owns the coal in place. It asserts that the facts "clearly negative any conveyance to the Contractors, or any ownership by them of the coal either in place or after extraction" (Par. Pet. 14); "Very plainly, therefore, the contractors had no property in that coal" (Par. Pet. 15); respondents are not entitled to depletion because they "did not own a single lump of coal when their work commenced, and did not own a single lump when they finished" (Par. Pet. 16); "Property, and property alone is the touchstone entitling to depletion" (Par. Pet. 16); and under the rationale of *Parsons* v. *Smith,* supra "the deduction for depletion inures only to those who have ownership of and capital investment in the minerals in place" (Par. Pet. 14).

If ownership of the mineral in place were essential to the depletion allowance, Treasury Department Regula-

tions[4] would so state, but they provide to the contrary. Section 1.611-1 (b) (1) of the regulations under the 1954 Code provides that "Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber." (Par. App. A10) If property is the only touchstone and ownership of the mineral is to control it would be simple to so provide by eliminating the words "an economic interest in."

The regulations adopted as its definition of an "economic interest" the following statement of the Supreme Court in *Palmer* v. *Bender*, 287 U.S. 551:

> "The language of the statute is broad enough to provide, *at least, for every case* in which the taxpayer has acquired by investment, *any interest* in the oil in place, and secures by *any form of legal relationship*, income derived from the extraction of the oil, to which he must look for a return of his capital." (Emphasis supplied)

The presence of such terms as "at least," "for every case", "any interest" and "any form of legal relationship" forecloses any concept that the depletion allowance is available only to the owner of the mineral deposit. Indeed the holding in *Palmer* v. *Bender*, supra, was that depletion did not depend upon any special form of legal interest in the mineral deposits. Recent Supreme Court cases reiterate this view. *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308; *Parsons* v. *Smith*, 359 U.S. 215.

Thus, under the regulations and decisions of the Supreme Court the essential requirement is not ownership of the coal as Paragon maintains, but ownership of an economic interest in the coal in place.

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[4] In *Parsons* v. *Smith*, supra, the Supreme Court noted that the language of the regulations with immaterial changes has remained unchanged since 1939.

After reviewing the controlling principles, this Court in *Parsons* v. *Smith*, supra, stated:

> "By their contracts which were completely terminable without cause on short notice, petitioners simply agreed to provide the equipment and do the work required to strip mine coal from designated lands of the landowners and to deliver the coal to the latter at stated points, and in full consideration for the performance of that undertaking the landowners were to pay to petitioners a fixed sum *per* ton."

Then the Supreme Court summarized the facts of the two cases before it and decided the case by stating:

> "* * * 'The controlling fact is that [petitioners] had no interest in the [coal] in place.' * * * petitioners simply entered into contracts, terminable without cause on short notice, with the owners of coal-bearing lands to provide the equipment and do the work required to strip mine and deliver coal from those lands, as independent contractors, for fixed unit prices."

In the case at bar the rights of the operators were not terminable without cause and they were not guaranteed fixed unit prices for the coal they produced. On the contrary, the agreements vested in the operators the continuing right to mine to exhaustion and to be paid as the mineral was extracted a price which was related to the market price of coal. Thus on the vital and controlling facts, this case is in accord with the principles and rationale of *Parsons* v. *Smith*, supra.

Paragon's claim that the Fourth Circuit significantly failed to follow *Parsons* v. *Smith*, supra, (Par. Pet. 13) and that *Parsons* is not law in that Circuit (Par. Pet. 17), is not supported by the facts. Since the *Parsons* case was decided, that Circuit has considered five cases involving this issue. in each of these cases, that Court has

judiciously adhered to the principles announced by this Court,[5] and it has not merely paid lip service to *Parsons*.[6]

In the instant case, the Fourth Circuit found that, unlike *Parsons* v. *Smith*, supra, the contracts with Paragon vested in the operators a continuing right to mine to exhaustion; they were paid a price for coal closely related to the market price; the contracts were not subject to termination and by their performance and expenditures under these agreements the operators acquired an economic interest in the mineral in place. By assuming and performing Paragon's obligation to mine the property, the operators relieved the lessee of the cost, burden and risk of development and mining and became entitled to a share of the capital reservoir represented by the coal in place. *Palmer* v. *Bender*, 287 U.S. 551, 53 S.Ct. 225; G.C.M. 22730, 1941-1 C.B. 214.

In *Parsons* v. *Smith*, 359 U.S. 215, this Court decided that the taxpayers claim to depletion was negated by certain facts which were listed at page 225. The facts of the instant case are quite different from those of the *Parsons* case. The principal investment of respondents was in the coal in place—not in equipment—and consisted of their assuming the obligation of developing their mines and extracting all mineable and marketable coal; their investments were not all recoverable through depreciation; the contracts were not completely terminable without cause on short notice; Paragon, the lessee, did agree to surrender and did actually surrender to the operators a

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[5] 1. *United States* v. *Stallard*, 273 F.2d 847
2. *McCall* v. *Commissioner*, 312 F.2d 699
3. *Elm Development Company* v. *Commissioner*, 315 F.2d 488
4. *Cooper* v. *Commissioner*, 330 F.2d 163
5. The instant case.

[6] The United States Court of Claims in *CBN Corporation* v. *United States*, 328 F.2d 316 (1964) at p. 323 cites with approval the Fourth Circuit's decision in *Elm Development Company* v. *Commissioner*, supra, stating that it contains an excellent discussion of the subject.

capital interest in the coal in place—that is Paragon surrendered its right to mine the coal itself or to determine whether it is mined or who is to mine it; Paragon agreed to handle all marketable coal and the price to be paid was closely related to the market price of coal; and the operators income was not dependent upon the personal covenant of Paragon without regard to the market price of the coal.

For the reasons stated, it is clear that the decision of the Court below is in accord with *Parsons* v. *Smith* and other decisions of this Court.

B. Paragon's Interpretation Of Section 631(c) Of The Internal Revenue Code Of 1954

Paragon insists that respondents are foreclosed from claiming depletion as a result of Section 631(c) of the 1954 Code. The provision relied upon by Paragon was first enacted as Section 325(b) of the Revenue Act of 1951, which amended Section 117(k)(2) of the 1939 Code. It was later carried into the 1954 Code as Section 631(c). The legislative history preceding the amendment of this provision contains nothing which would suggest that Congress intended to make Sections 611(b)(1) inapplicable to coal leases. Moreover, neither the Treasury Department in its regulations or the Government in litigation has placed such an interpretation on this section—even though the statute has been in existence for over twelve years. Paragon does not cite any Committee Reports, Treasury Department Rulings or decided cases in support of its interpretation, nor can it do so since all authority is to the contrary.

Section 631(c) provides that in certain situations an owner who disposes of coal under any form or type of contract by virtue of which he retains an economic interest in such coal shall not be entitled to the allowance for percentage depletion, but shall be entitled to treat any gain as long term capital gain. In the case of these own-

ers, Congress substituted one form of tax treatment for another. Congress did not, however, change the principle long recognized by the courts that a number of taxpayers may hold an economic interest in a mineral deposit and share in the depletion allowance. Sections 1.611-1(c)(1) and (2) of the Regulations (Appendix 14) refers to "several owners of economic interests" and "in the case of a lease or *other contract* providing for the sharing of economic interests in a mineral deposit or standing timber". (Emphasis supplied) These regulations apply to all mineral deposits including coal.

C. Decision Of The Court Of Appeals Will Not Have Serious Litigation-Breeding Consequences.

Paragon's fear that the decision below will cause the volume of depletion litigation to increase is without foundation. The Commissioner of Internal Revenue, who would be most concerned with such an increase, does not share Paragon's fear (Comm'r. Mem. Op. 3). The rationale of *Parsons* v. *Smith*, supra, is well understood by contracting parties in the coal fields of Virginia and West Virginia. Agreements entered into subsequent to that decision are clear as to the question of the respective rights of the parties to the depletion allowance. Pending coal depletion cases involve oral agreements which were entered into prior to *Parsons* v. *Smith*, supra.

The instant case involves oral agreements made in 1952, 1953, 1954 and 1955 and the companion case of *Commissioner* v. *Cooper et al*, No. 262 involves oral agreements made prior to 1953. In both cases the coal mine operators claimed a right to mine a specific area to exhaustion and the lessee coal companies contended that they could terminate the agreements at will and without cause. Other factors indicative of an economic interest in the coal mine operators were not seriously questioned by the lessee coal company in either case.

Section 611 of the 1954 Code provides for a reasonable allowance for depletion, "according to the peculiar conditions in each case". Paragon is a processor and seller of coal rather than a producer. It had certain production obligations under its lease, but it lacked the capital necessary to engage in the coal producing business. The operators agreed to perform Paragon's obligations under its leases and made large expenditures of time and money in preparing their respective sites for mining and in developing their mines and producing coal. On the basis of these undisputed facts, the Court of Appeals determined that Paragon could not remain silent on the point of termination and then take the benefit of the operators efforts at will and without cause; and that if it intended any limitation on the operators rights the burden was on Paragon to express such limitation.

The Fourth Circuit understands the peculiar conditions in the coal fields of Virginia and West Virginia. It considers legal problems related thereto on a frequent and continuing basis. Prior to *Parsons* v. *Smith*, supra, many coal producing agrements in that area were verbal—now such agreements are written and the rights of the parties to the depletion allowance can be easily determined from the contract provisions. Refund claims in large numbers will not be filed. For all but a handful of taxpayers, the question of the depletion allowance on the production of coal has been settled long ago.

CONCLUSION

The petition for writ of certiorari would serve no useful purpose and should therefore be denied.

Respectfully submitted,

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August 1964

APPENDIX

REGULATION

"§ 1.611-1 *Allowance of Deduction For Depletion.* (a) *Depletion of mines, oil and gas wells, other natural deposits, and timber—(1)(c) Special rules—* (1) *In General.* For the purpose of the equitable apportionment of depletion among the several owners of economic interests in a mineral deposit or standing timber, if the value of any mineral or timber must be ascertained as of any specific date for the determination of the basis for depletion, the values of such several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral or timber as a whole.

"(2) *Leases.* In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interests in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder."